No. 12,664

IN THE

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER, and LILLIE S. WEGEFORTH,
Respondents.

Brief in Support of Respondents' Petition for Rehearing

On Behalf of Adolph B. Spreckels and Dorothy C. Spreckels, Taxpayers and Respondents in Commissioner of Internal Revenue, Petitioner, v. Adolph B. Spreckels, et al., Respondents, No. 12,663.

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TABLE OF AUTHORITIES CITED

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By stipulation entered into between counsel and approved by this Court on October 25, 1950, it was stipulated that counsel for respondents in the *Spreckels'* case above mentioned (No. 12,663) should have the privilege of filing a brief, either as amicus curiae or on behalf of said respondents, in the entitled proceeding. Accordingly, this brief is now presented in support of the Petition for Rehearing filed by respondents herein.

It is respectfully submitted that the Court, in its opinion dated November 5, 1951, in effect begs the question presented in this case, and fails to consider and be guided by the Supreme Court's opinion in *Helvering v. Canfield,* 291 U.S. 163 (1934).

I.

The question presented to the Court was whether or not certain corporate distributions were taxable income to the recipients within the meaning of Section 115(a)(1) of the Internal Revenue Code.

The Court summarizes its thinking in the last paragraph of its opinion, saying

> "* * * The present statute is here construed in the light of its language and the broad purpose to tax all *income.* That taxpayers should escape the common burden of taxation, which falls on the just and unjust alike on *income* currently received, simply because the corporation which made the distribution from current earnings had losses over thirty-five years ago, before the Constitution permitted unapportioned taxation of income, is inconceivable." (Emphasis added.)

If the distributions concerned were *income,* it would indeed be inconceivable that the respondents should escape taxation thereon. But the question itself is whether the distributions were or were not income.

The Court has confused the character of the money involved in the hands of the corporation with its character in the hands of the stockholder-respondents. The Court presents as an illustration the example of an individual insolvent as of February 28, 1913; such individual is of course analogous to the corporation. It goes on to note that "after

* * * [February 28, 1913], taxation of all sums received as income was possible," and that "the power to tax" and "the intention to burden" all income after that date is incontrovertible. Finally, it quotes from the dissenting opinion of the court below, that

> "Since the money here involved as distributed to stockholders was in fact earned by the corporation since February 28, 1913, it is to be presumed that Congress, intending to use its taxing power to the fullest extent, intended to tax such funds."

All of the foregoing apply to the situation of the corporation, about which there is no argument. No one would deny that the corporation is taxable on its earnings after February 28, 1913, regardless of its having had a deficit on that date. But to say that what is income to the corporation is income to the stockholders, and that Congress intended the double taxation of such funds, is a different matter, and one that the Court fails to meet squarely. On the contrary, although admitting that what the respondents actually received was capital to them, the Court bases its opinion entirely on the assumption that they received taxable income, the very question at issue.

In making such an assumption, the Court has ignored or dismissed without any consideration the many cases holding that distributions of a corporation made in the face of an operating deficit incurred after February 28, 1913, must be regarded as capital return to the distributee and not income.* The Court mentions that "this is a plausible inter-

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**Foley Securities Corp. v. Commissioner,* 106 F.2d 731 (C.C.A. 8th, 1939); *Crystal Ice Co.,* 14 B.T.A. 682 (1928); *J. L. Washburn,* 16 B.T.A. 1091 (1929); *Louise Glaswell Shorb,* 22 B.T.A. 644 (1931); *Arthur C. Stifel,* 29 B.T.A. 1145 (1934); *Roy J. Kinnear,*

pretation" "for corporations organized since March 1, 1913," but in fact the rule of these cases is not so confined, and several of the corporations involved had corporate life prior to that date.†

Moreover, the holding of the Court must result in taxing respondents on receipt of capital, and if Section 115(a)(1) of the Internal Revenue Code is so construed, it is in violation of Section 2 of Article I of the Constitution of the United States, for levying a direct tax not apportioned among the several states. *Pollock v. Farmers Loan & Trust Co.,* 157 U.S. 429 (1895). It does not appear from the Court's opinion that the Court gave any consideration to the constitutional question, a failure probably occasioned by its adoption of the erroneous assumption described above.

II.

In holding that the corporate distributions in question constituted taxable income, the Court has failed to follow the reasoning of the Supreme Court in *Helvering v. Canfield, supra,* and has apparently not given due consideration to the case (it is mentioned only in a footnote without discussion).

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36 B.T.A. 153 (1937); *Shellabarger Grain Products Co.,* 2 T.C. 75 (1943). See also *Loren D. Sale,* 35 B.T.A. 938 (1937); G.C.M. 1552, VI-1 C.B. 10 (1927). Cf. *Willcuts v. Milton Dairy Co.,* 275 U.S. 215 (1927), holding that there can be no earned surplus or undivided profits until any deficit or impairment of a corporation's capital has been made good.

†See the *Crystal Ice Co., Washburn* and *Kinnear* cases, *supra.* The rule is stated in the *Kinnear* case as follows:

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored."

In that case, the taxpayer-stockholders contended that Congress had drawn a line between February 28 and March 1, 1913, and that their corporation's surplus as of that date could therefore be disregarded, and its later deficits be used to offset its later earnings (under the rule of the *Crystal Ice Co.* and other cases, *supra*), to the end that it would be said to have no "accumulated earnings" within the meaning of the statute.*

But the Supreme Court refused to draw such a line. Instead the Court decided that in order to determine the character of corporate distributions, the entire life history of the corporation must be taken into account. It found that the stockholders of the corporation involved did indeed receive income, because their corporation's post-1913 losses were offset by its pre-1913 surplus. Surely the same court, looking at the converse situation in the instant case, would again refuse to draw a February 28-March 1, 1913, line, and would find no accumulated earnings in the Spreckels Company at the time in question.

The holding of the *Canfield* case forces the conclusion that the term "accumulated" refers back to the inception of corporate life to commence building the "accumulation." In effect, the Supreme Court held that the language "* * * (1) out of its earnings or profits accumulated after February 28, 1913 * * *" in Section 115(a)(1) must be interpreted to read "* * * (1) out of its earnings or profits accumulated from the date of incorporation, provided that those accumulated prior to March 1, 1913, shall not be included therein

*Section 201(a) of the Revenue Act of 1921, substantially the same as Section 115(a)(1) of the Internal Revenue Code, involved in the instant case.

to the extent that they are intact at the time of such distribution * * *"

Applying the statute in such form to the instant case would leave no argument that the distributions to the Spreckels' stockholders could be considered pro tanto taxable dividends, since there would not be, to the extent described in the stipulation of facts, any accumulated earnings or profits. It is therefore submitted that the Court's holding herein is in conflict with the Supreme Court's interpretation of the statute in the *Canfield* case.

For the foregoing reasons, it is urged that respondents' Petition for Rehearing be granted.

Respectfully submitted,

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Dated: December 4, 1951